SUPPORTING BRIEF.

I.

OPINIONS OF THE COURTS BELOW.

The findings of fact and conclusions of law and decree of the said District Court below appear at pages 161-173, inclusive, of the record and are not reported.

The opinion of the said Circuit Court of Appeals (R. p. 182) is not as yet reported.

II.

JURISDICTION OF THIS COURT.

1.

Jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925, 43 Stat. 938 (28 U. S. C. A., Sec. 347).

2.

The following decisions sustain the jurisdiction of this Court to review the decision of the Circuit Court of Appeals for the reasons set out in the specifications of error:

Warner v. New Orleans, 167 U. S. 467;
Ivanhoe Building & Loan Association of Newark v. Orr, 295 U. S. 243;
Erie Railroad Company v. Tompkins, 302 U. S. 671, reported 304 U. S. 64.

III.

Inasmuch as the payee of the certificate sued on was not entitled under the terms of the contract, under any cir-

cumstances, to profit or gain and as the contract provides for a definite time of payment (though dependent on a contingency), there is no basis for the holding of the court below that the payee of the certificate occupies a position analogous to that of a stockholder.

See authorities cited supra under Point I of Reasons for Allowance of Writ, p. 12.

IV.

A pledge by an insurance company of future savings and profits of its insurance business for a proper corporate purpose is a valid pledge.

See authorities cited under Point II, supra, p. 13.

V.

One does not become a stockholder in a corporation merely because he advances money under a contract which provides that it is payable out of future earnings and profits.

See authorities cited under Point IV, supra, p. 14.

VI.

The original date of the judgment of said Circuit Court of Appeals, here sought to be reviewed, is July 12, 1940 (R. p. 189). Petitioner's petition for rehearing was duly filed in said Circuit Court of Appeals on August 5, 1940 (R. p. 202), and was overruled on August 19, 1940 (R. p. 202).

VII.

STATEMENT.

A full statement of the case has been made in the petition for writ of certiorari, and, in the interest of brevity, the statement is not here repeated.

VIII.

SPECIFICATIONS OF ERROR.

A.

The Circuit Court of Appeals for the Tenth Circuit erred in deciding and adjudging that the petitioner's status as holder of the participating certificate or written agreement for the repayment of the $300,000.00, set out at record page 22, is analogous to that of a preferred stockholder, and in holding that for such reason the petitioner is not a creditor and not entitled to repayment of the money advanced out of savings and profits realized by the reinsurer, the Occidental Life Insurance Company, out of the reinsured business of The Federal Reserve Life Insurance Company.

B.

The Circuit Court of Appeals for the Tenth Circuit erred in deciding and adjudging that the provision in the said participating certificate that "in the event of a reinsurance of the business of The Federal Reserve Life Insurance Company the reinsuring company shall be bound each six months to pay the savings and profits arising out of the reinsured business * * * to the then holder or holders of this certificate," had reference only to a voluntary reinsurance of the business and not to reinsurance of the business in connection with the transfer and conveyance of the assets of the Federal Reserve in judicial proceedings.

C.

The Circuit Court of Appeals for the Tenth Circuit erred in deciding and adjudging that the sale and transfer of the assets of The Federal Reserve Life Insurance Company under order of the Court in receivership proceedings was

equivalent in law to a foreclosure of the paramount lien or interest of the policyholders and that the right of the claimant was analogous to that of a preferred stockholder and that such foreclosure extinguished any claim on its part to the gains and profits thereafter accruing to the business under the ownership and operation of the Occidental Life Insurance Company.

IX.

ARGUMENT.

POINT I.

(Assignment of Error A.)

As to the Proposition That the Holder of the Certificate Occupies a Position Analogous to That of a Preferred Stockholder.

We respectfully submit that the Court is in error in holding that the relationship between the owner of the certificate and the policyholders and other creditors is substantially analogous to that ordinarily existing between a preferred stockholder and creditors. In this case the Fire Insurance Company of Chicago, at the time it entered into the agreement with the Insurance Investment Company to advance the $300,000.00 evidenced by the certificate, was not a stockholder and, if the written contract under which it advanced the money is clear and unambiguous, its rights should not be determined by the motives which may have influenced the borrowing company and the Insurance Investment Company, which was the owner of part of its stock. The instrument itself is simply a promise to pay the $300,000.00 advanced with 6 per cent interest, with the further provision that the Federal Reserve was not bound by an absolute promise but only under a contingent liability to pay out of a fund to be set aside semiannually, made

up of net surplus gains in excess of $50,000.00. The certificate undertakes to fix a different liability upon the reinsuring company in the event of a reinsurance of the business of the Federal Reserve. In that case it provides:

> "The reinsuring company shall be bound each six months to pay the savings and profits arising out of the reinsured business * * * to the then holder or holders of this certificate * * * until the full balance of interest and principal due thereon shall have been paid."

There is an obvious difference between "net surplus gains" of the company, out of which the original obligor was bound to pay, and "savings and profits" of the reinsured business, out of which the reinsurer was bound to pay. Savings and profits of an insurance business are made up of mortality savings, cash surrender charges, and profits from lapses (R. pp. 144-5). Such savings and profits might exist in case of a certain group of policyholders, even though the reinsuring company carrying on the business might not realize any net surplus gains. But, however the contract embodied in the certificate may be viewed, we submit that there is nothing in it which justifies the conclusion that the rights of the holder of the certificate are analogous to the rights of a preferred stockholder.

The right of a stockholder, either common or preferred, is to receive repayment of his contribution to the corporation only after all creditors of the corporation have been entirely satisfied. The reason underlying this is that the stockholder is identified with the corporation itself as owner and manager. He is not limited simply to the repayment of his investment with interest, but may receive dividends on his investment measured only by the life and success of the corporation, with the possibility, on liquidation of the assets, of receiving back his entire investment, or possibly more.

Under the terms of the certificate here under consideration the holder of the certificate differs from a stockholder in this:

1. He could never, under any circumstances, receive back more than the money advanced, together with interest at the prescribed rate, which in this case was 6 per cent.

2. There is nothing in this certificate which gives the holder or owner of it any proprietary rights in the corporation whatsoever or any voice in its management.

We submit that no case will be found in the books, and none has been cited in the opinion of the court below, where it is held that a person becomes a stockholder, either common or preferred, who merely lends money to a corporation without any prospect of gain except to receive back his money with interest and without any right of management or in the final distribution of the assets such as appertain to a stockholder of a corporation.

The leading and original authority on this subject, which is cited and relied on both in Hamlin v. Toledo, St. L. & K. C. R. Co., 78 F. 664, and In Re Lathrap, 61 F. (2d) 37, cases cited in the opinion of the Court of Appeals, is the case of Warren v. King, 108 U. S. 389. In that case it appeared that in one of the reorganizations of a railroad company certain persons who had theretofore occupied the position of creditors accepted preferred stock. These certificates of preferred stock provided, among other things, that:

> "The preferred stock is to be and remain a first claim on the property of the company after its indebtedness and the holders thereof shall be entitled to receive from the net earnings of the company 7 per cent per annum, payable semi-annually. * * *"

It further appeared from the certificate that payments to preferred stockholders were not limited to any particular

period, nor was the right of the holder of the preferred stock limited to a return of the amount of the indebtedness for which the preferred stock was substituted. It was contended by the holder of the preferred stock that it was entitled to the benefit of a lien on all the assets of the company existing at the time the preferred stock was issued, subject only to certain indebtedness then existing, and that this lien was superior to the claims of subsequent creditors. It was held that such preferred stockholder had no priority over subsequent creditors by virtue of the lien sought to be set up by the certificate. The reason underlying the Court's decision is set out in the opinion at page 399 as follows:

> "There is nothing in the certificate which clothes them with a single attribute of a creditor, while it specially gives them, as stockholders, equal interest with the common stockholders in the excess of net earnings in one year after paying therefrom 7 per cent on each share of stock, preferred and common.
>
> "Whatever position the holders of preferred certificates occupied before they accepted preferred stock, whatever special rights of lien they had, they became corporators, proprietors, shareholders, and abandoned the position of creditors, and took up towards existing and future creditors the same position which every stockholder in a corporation occupies towards existing and future creditors. **His chance of gain, by the operations of the corporation, throws on him, as respects creditors, the entire risk of the loss of his share of the capital, which must go to satisfy the creditors in case of misfortune.** He cannot be both creditor and debtor, by virtue of his ownership of stock. In this case, all the parties holding trustees' certificates united to form a new corporation, converted themselves into stockholders in it.
>
> "It must be clear that, if the trustees, representing the holders of trustees' certificates, had gone on and operated the road for them, not organizing a new com-

pany, any debts contracted by the trustees in the business would have had priority over the claim of the holders of such certificates. So, in becoming stockholders in the new company, with the right to vote as to its management and to share in its earnings, they must have intended to allow, through the corporation, a priority of debts over their claims as stockholders." (Emphasis ours.)

The case of Hamlin v. Toledo, St. L. & K. C. R. Co., 78 F. 664, cited by the court below in support of its conclusion that appellant occupies a position analogous to that of a stockholder, is a well-considered opinion of the Sixth Circuit written by Judge Lurton and participated in by Judge Taft. Here again, as in the Warren case, it appears that certain intervenors in a receivership proceeding were holders of preferred stock. The certificates designated the holdings as preferred stock and undertook to provide that the stock should carry a lien on the profits and net earnings of the company, subject only to a first mortgage, and that the company would create no lien on its profits other than the first mortgage except subject to the lien of the certificates. The holders of this preferred stock undertook to enforce this lien as against subsequent creditors. The certificate is set out on page 668 of the opinion. It was held by the Court that this attempt to create a lien as against creditors subsequent to the first mortgage creditors was void and that the holders of this preferred stock took subject to the rights of all creditors. The reason underlying the decision of the Court is set forth at pages 670-671 of the opinion as follows:

"There is a wide difference between the relation of a creditor and a stockholder to the corporate property. One cannot well be a creditor as respects creditors' property and a stockholder by virtue of a certificate evidencing his contribution to the capital of the corporation. Stock is capital, and a stock certificate but

evidences that the holder has ventured his means as a part of the capital. It is a fixed characteristic of capital stock that no part of it can be withdrawn for the purpose of reimbursing the principal of the capital stock until the debts of the corporation are paid. These principles are elementary. Warren v. King, 108 U. S. 389, 2 Sup. Ct. 789; Cook, Stock, Stockh. & Corp. Law (3rd Ed.), Section 771. **The chance of gain throws on the stockholder, as respects creditors, the entire risk of his contribution to capital.** 'He cannot be a creditor and debtor by virtue of his ownership of stock.' Warren v. King, supra. If the purpose in providing for these peculiar shares was to arrange matters so that, under any circumstances, a part of the principal of the stock might be withdrawn before the full discharge of all corporate debts, the device would be contrary to the nature of capital stock, opposed to public policy, and void as to creditors affected thereby. Cook, Stock, Stockh. & Corp. Law (2d Ed.), Sections 270, 271; Chaffee v. Railroad Co., 55 Vt. 110; McCutcheon v. Capsule Co., 19 C. C. A. 108-115, 71 Fed, 787; Morrow v. Steel Co., 87 Tenn. 262, 108 S. W. 495. If that was the purpose of this arrangement, most doubtful language was employed. There is a sense in which every shareholder is a creditor of the corporation to the extent of his contribution to the capital stock. In that sense, every corporation includes its capital stock among its liabilities. But that creditor relation is where it exists only between the corporation and its shareholders. It is a liability which is postponed to every other liability, and no part of the capital stock can be lawfully returned to the stockholders until all debts are paid or provided for. The violation of this well-understood principle is a breach of trust, and a corporation affected thereby may pursue the stockholders and recover as for an unlawful diversion of assets." (Emphasis ours.)

The other case cited by the court below upon the proposition here under consideration is In Re Lathrap, 61 Fed. (2d) 37. This case differs from the others cited in that it

was not, like the case at bar, a proceeding in equity wherein it was sought to establish an equitable lien. It was a bankruptcy proceeding. The bankrupt, by written assignment, had undertaken to assign to Rose W. Lamberton and others a royalty interest equivalent to a certain percentage of the gross proceeds received from the sale of 100 per cent of the oil and gas produced in certain wells in process of being sunk. The case discusses various questions with reference to the purchase of and transferring title to oil and gas in the ground and applicable California statutes which are entirely foreign to the question under consideration here. However, the Court also held that the purchaser of such an interest was a co-adventurer in the business. It will be observed that the holders of these certificates were not limited to a repayment of their money as a loan with interest. The profits were limited only by the productive capacity of the well. On this phase of the case the Court, again relying on the fundamental principles laid down by the Supreme Court of the United States in Warren v. King, supra, at pages 43-44 of the opinion said:

> "Although per cent holders are a recent product of corporate finance, and therefore, in a sense sui generis, they bear a close analogy to preferred stockholders. As to the rights and risks of the latter, the Supreme Court has this to say, in Warren and Others v. King and Others, 108 U. S. 389, 399, 2 S. Ct. 789: 'Whatever position the holders of preferred certificates occupied before they accepted preferred stock, whatever special rights of lien they had, they became corporators, proprietors, shareholders, and abandoned the position of creditors, and took up towards existing and future creditors the same position which every stockholder in a corporation occupies towards existing and future creditors. **His chance of gain, by the operation of the corporation, throws on him, as respects creditors,** the entire risk of the loss of his share of the capital, which

must go to satisfy the creditors in case of misfortune. He cannot be both creditor and debtor, by virtue of his ownership of stock.

"So in the instant case. Whether or not the per cent holders come under the technical classification of stockholders, they are—like stockholders, partners or joint adventurers—'investors' participants in the common enterprise. Had the bankrupt prospered and continued the operation of the oil well, these per cent holders would have prospered with him, **to an extent that their certificates did not even attempt to limit.** Conversely, these same holders must be prepared to share in the bankrupt's misfortunes. There is no equity in their favor that places them in a position equal to that of general creditors, who sold merchandise or labor at only a nominal profit. The creditors should not be the first to be sacrificed. It is the 'investors' who should be ready to take the bitter with the sweet."

We submit that the difference between rights of the holder of the certificate under consideration here and the rights of stockholders is fundamental and is clearly pointed out in the above cases cited in the Court's opinion. This certificate did create an equity in favor of the holder superior to that of general creditors. The payee of the certificate was a creditor only in that it gave the holder no right of proprietorship or ownership of the corporation making the promise—no rights except to receive back the money with interest.

We submit that none of the cases cited is authority for the proposition that the certificate creates a relationship analogous to that of a stockholder of preferred stock merely because the money was payable by the company out of any particular fund, however designated. It is the opportunity for unlimited gain which constitutes the difference between a stockholder and a creditor, and not the fund out of which the money advanced is payable.

The Court, in arriving at its conclusion that this $300,000.00 was merely a contribution to capital and that the certificate conferred only stockholder's rights, lays emphasis upon the fact that the capital was impaired and that it was necessary to restore it. This was all true from the standpoint of the debtor corporation and its stockholders, but the motive which influenced the borrower, that is, the motive to replenish its capital, and the fact that it used the money for that purpose, can not make the lender, the Fire Insurance Company of Chicago, a stockholder simply because that was the purpose of seeking the loan. The certificate gives the Fire Insurance Company of Chicago, or any holder thereof, only the rights of a lender, limited to the repayment of the moneys advanced, with interest, out of a certain fund, but no rights of proprietorship in the company whatever. The fact, therefore, that the borrower may have used the money to replenish its capital and that the lender may have known that was the purpose of contracting the debt, cannot make the lender a stockholder.

Furthermore, the Court places emphasis upon the fact that the Federal Reserve, in keeping its accounts, never carried this $300,000.00 as a liability. We submit that is no part of the background or circumstances accompanying the loan which should be considered in determining the meaning of the certificate, even if its meaning were doubtful. The borrower cannot affect the rights of the lender by the manner in which he keeps his books or makes his reports to any supervising authority. There is no evidence in the record that the Fire Insurance Company of Chicago or any holder of this certificate had any participation in this sort of bookkeeping or even any knowledge as to how this liability was carried on the books or whether it was noted on the books at all. Furthermore, such knowledge on the part of the creditor or holder of the certificate, if it existed, could not affect the rights created by the certifi-

cate which designates the liability as a contingent liability payable under the circumstances therein set forth.

The opinion of the Court below in the case at bar is contrary to the principles laid down by the Supreme Court of the United States in the case of Ketchum v. St. Louis, 101 U. S. 306, as well as those laid down by the Court below in the case of Stone v. Wright, 75 F. (2d) 457. The situation in each of these cases is analogous in that, in both, the money advanced was payable out of earnings or profits. However, a definite sum was payable, that is the money advanced with interest in the Ketchum case and simply the money advanced in the Wright case. This was the feature which placed the claimant of an equitable lien in each of these cases in the position of a lender or creditor and not a stockholder. The situation is the same here, and in denying the appellant the relief sought the Court below reaches a conclusion directly contrary to that before announced by the Supreme Court and by the Court below in the cases last above cited.

B.

As to the Proposition That the Certificate in Undertaking to Fix the Liability of a Reinsuring Company Had Reference Only to Voluntary Reinsurance.

We respectfully submit that the Court below was in error in holding that the parties to the contract embraced in the certificate contemplated only a voluntary reinsurance and had no reference to reinsurance in connection with receivership proceedings. The language of the certificate itself shows that it contemplated the reinsurance of the business by another company than the original obligor. This obligation is to arise "in the event of a reinsurance of the business of The Federal Reserve Life Insurance Company." This language, in its natural scope and meaning, covers any reinsurance, whether voluntary or involuntary. We

submit that there is nothing in the circumstances to indicate that the parties had any purpose to restrict the natural scope and meaning of the words used so as to cover only voluntary reinsurance. Indeed, the circumstances—if it is necessary to look into the circumstances in order to arrive at the meaning of the language, which is plain in itself—indicate that in making this provision the lender of the money was seeking to protect itself against involuntary reinsurance in receivership proceedings. The parties very well knew that there are two kinds of reinsurance, both dependent for their validity on the consent of the policyholders reinsured; one, a reinsurance, voluntary in character, arising solely out of contract between the original company and the reinsurer with the consent of the policyholders, and the other a reinsurance in receivership proceedings independent of the consent of the original company but also dependent for its validity on the consent of the policyholders. The parties must have known that, in case of insolvency, reinsurance is the usual method of protecting the interest of the policyholders. They must have known that in such event the policyholders had a right to take down their share of the assets or to accept the proposed reinsurance arrangement. They must have known that it would be greatly to the interest of the policyholders to accept any reasonable reinsurance arrangement and that, in the ordinary course of events, the great majority of the policyholders would do so, as they did in this case. In arriving at this conclusion, we submit that the Court below leaves out of consideration this important fact, to wit, that notwithstanding the fact that the capital was impaired at the time this money was advanced and the reserve was impaired, the lender, by separate transaction contemporaneous with the lending of the money and for a separate consideration, acquired the ownership of a majority of the stock of The Federal Reserve Life Insurance Company. (See statement supra, p. 7.) With the com-

pany in the condition that it was at that time, this stock in and of itself could not have been a very attractive investment. At least one natural reason for acquiring that stock was that the lender might be able, through a majority stock control of the company, to protect its contingent obligation in case of any voluntary reinsurance contract entered into by the company. It was not necessary for the certificate itself to provide for protection in case of voluntary reinsurance because the lender itself had control of that situation. The company being in distress at the time, it was naturally in contemplation of the parties that it might be in trouble again. Therefore, this provision as to what the rights of the holder of the certificate should be in the event of any reinsurance was placed in the certificate for the obvious purpose of protecting the lender against a reinsurance in court proceedings, which the majority stockholder could not control.

We submit that for the Court to hold that the lender in entering into such an agreement had reference only to a voluntary reinsurance is to assume that the lender was wanting in ordinary intelligence and understanding of the situation and in the ordinary instinct of self-preservation. If it were legal to provide that, in the event of a reinsurance through court proceedings, the lender of the money covered by this certificate should have the rights provided for in the certificate, then it is not reasonable to suppose that the parties did not intend to give the lender all the protection that the circumstances permitted.

We submit that there is nothing in the circumstances whatever to show that they had any other intention. It is a well-recognized fact, as appears from the record, that a given volume of insurance in force has a value as a source of profits and income separate and apart from the assets which constitute the reserve. The reserve is a trust fund set aside solely for the benefit of policyholders, but the policyholders have no interest in any other assets of

the company, either actual or potential, which prevents the company in the course of its ordinary business from borrowing money on the security of such other assets. It did borrow money in this case on the security indicated. The policyholders were given the benefit of it. It is not sought now to take away from the policyholders one cent of the $300,000.00 which was placed in the reserve fund for their sole benefit. The effect of the decree is to deny to this claimant the sole security given to it as a contingent creditor for the money advanced. The policyholders had no interest in the savings and profits in this business until after the insolvency and until after the reinsurance contract approved by the decree of the Court below gave the policyholders an interest in those savings and profits. We submit that the Court below had no right to do that except subject to the valid lien on such possible savings and profits which had theretofore been created for the purpose and with the result of contributing $300,000.00 to the fund in which the policyholders were solely interested.

C.

As to Foreclosure of Lien by Sale and Transfer of the Assets.

The Court below held that:

> "The sale and transfer of the assets under order of the Court in the receivership proceeding was equivalent in law to a foreclosure of the paramount lien or interest of the policyholders. Since the only right which claimant had was analogous or akin to that of a preferred stockholder, such foreclosure extinguished any claim on its part to the gains and profits thereafter accruing to the business under the ownership and operation of Occidental."

Of course, it is true that, if the rights of the claimant are analogous or akin to those of a preferred stockholder,

then, inasmuch as the company was confessedly insolvent, the claimant has no right to any reimbursement. On the authority of the cases above referred to and cited in the opinion of the Court below, we submit that claimant is in the position, not of a preferred stockholder, but of a creditor. It simply loaned this money with no hope of gain except repayment of the money itself with lawful interest. It has never been held that such a person was a stockholder, co-adventurer, or joint proprietor, or that he occupies any other position than that of creditor with a claim payable upon the contingency indicated in the contract.

The sale and transfer of the assets, it is true, cut off all rights, both of policyholders and of all other persons, in those assets except to the extent provided in the reinsurance contract. The policyholder had the right to take his share of the assets. When he elected not to do that, he took only under the reinsurance contract and subject to the rights and restrictions contained in that contract. The reinsurance contract itself provides that the Occidental should have the right to reimburse itself for any moneys paid out which were properly a charge against the Federal Reserve fund (R. pp. 51-52). Under the reinsurance contract, the Federal Reserve fund included not only the tangible assets constituting the reserve fund but also the savings and profits from the reinsured business itself, that is, such savings and profits as might result from mortality savings, cash surrenders and other fees which an insurance company ordinarily looks to as a source of profit. This claimant has a lien in every sense equitable and just on such profits. Therefore, when the policyholders accepted this reinsurance agreement with full knowledge, through the Receiver, of the existence of this claim, they consented to whatever rights might arise out of the situation and the reinsurance contract in favor of the holder of this certificate. The paramount lien of policyholders was foreclosed on tangible assets constituting part of the reserve, but the

stockholders had no lien whatever on possible savings or profits of the business which is the subject matter of our claim.

CONCLUSION.

Being desirous of not burdening the Court with an unduly lengthy argument, and having called the Court's attention specifically to the questions involved and to the reasons that exist for the issuance of the writ of certiorari, we will not argue the errors assigned at greater length.

It is respectfully submitted that this case is one calling for the exercise by this Court of its supervisory powers by granting a writ of certiorari and thereafter reviewing and reversing the said decision.

Respectfully submitted,

WILLIAM L. MASON,
Counsel for Petitioner.